Economic Insights

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David Hume

Foundations of the Classical School of Economics

David Hume is primarily known as a philosopher and chronicler of English history. Less well known is his work on economic theory and several political economy issues, some of which remain salient today. Studying his economic work enables us to see how he reshaped John Locke's quantity theory of money and how he influenced the great Adam Smith, Hume's close friend and fellow Scottish Enlightenment philosopher. Hume is one of the pillars of the classical school of economics, primarily founded by Smith. This issue of Economic Insights *offers some of Hume's economic theorizing for those who want to pursue the intellectual history of modern economic theory.*

—**Bob McTeer**
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Adam Smith is the founder of the classical school of economics, but economic theorizing predates Smith. The philosophic foundations of classical economics are found in the work of the Scottish Enlightenment thinkers of the early to mid-18th century, centered around the University of Edinburgh. Notable among these great thinkers and writers is David Hume.

Hume was born in Edinburgh, Scotland, on May 7, 1711. The extent to which Hume influenced Smith, his close friend, has to be inferred from their respective writings, but the warmth and depth of their relationship is incontestable. Smith said of Hume:

> Upon the whole, I have always considered him, both in his lifetime and since his death, as approaching as nearly to the idea of a perfectly wise and virtuous man as perhaps the nature of human frailty will admit. (Goldberg 1961)

Like Smith, Hume tried to use Isaac Newton's method of analysis in his inquiries. Hume also borrowed from philosopher John Locke's epistemology as he related mostly moral concerns. Hume saw such moral concerns as the thread that connected his various writings, which included political economy.

While we shouldn't overemphasize Hume's economic influence on Smith, their relationship—especially in light of the similarities of some of their analyses—is intriguing. As Roll (1953, 117–18) writes:

> In recent years the tendency has even arisen to regard him [Hume] as the most important of the pre-Smithian economists….[T]hey [Hume's economic essays] are all clearly written and often contain an excellent summary and synthesis of the ideas of his predecessors. In that respect, however, Cantillon's *Essai sur la nature du commerce en général*, published in 1755, but written over twenty years previously, is superior.

It is impossible to know whether Smith was more influenced by Cantillon's book or by personal discussions with Hume. Schumpeter (1954, 124) argues that Hume did influence Smith, and Rothbard (1995, 430) suggests that Hume was one of Smith's mentors. O'Brien (1975) gives Hume a large role in the development of classical economic thought because of his participation in spreading natural law philosophy.

On the question of self-interest's role in human affairs, Hume seems to have influenced Smith greatly. For Hume, and for much of the Western world after him, self-interest became the primary motivating force that explained most of social reality (Herman 2001, 170). Hume's early book expounding his idea of self-interest, *A Treatise of Human Nature* (1734), may have cost him a university teaching position. The work so horrified other philosophers that some—notably Francis Hutcheson—actively sought to deny him such a position. He later repudiated this first book. However, this was not the last time Hume offended prevailing sensibilities and challenged majority opinion on an issue.

Hume's view that self-interest could be channeled profitably only through economic cooperation and competition—making civil society a possibility so long as the rule of law prevailed—was a pillar of Smith's thinking as well.

In this regard, Hume's influence on Smith is both clear and profound. Government is required, they argued, because instinct may cause people to act against their interests, even though they are driven primarily by those self-interests (Rotwein 1987, 693).

Philosophers see Hume as a direct link between the empiricist political philosophy of Locke, the French laissez-faire Physiocratic movement led by Francois Quesnay and early British political economy. Hume's economic views overlapped both the mercantilist and classical traditions, depending on the topic he addressed, but were generally pro-free trade and antimercantilist. Because of his extreme skepticism and presumed atheism, as well as his view of human nature, academe was closed to him. He pursued instead a career in public life, traveling for tutoring positions, becoming British chargé d'affaires in Paris and eventually becoming undersecretary of state. He retired from public life in 1769 and returned to Edinburgh.

Hume's most important foray into economic theory was his discussion of the price-specie-flow mechanism. The movement of specie (gold and silver) between countries balances trade and automatically adjusts international trading partners' domestic price levels. As such, its intellectual lineage comes directly from the quantity theory of money—traceable back to Locke—as it was applied to international trade balances.

Hume's economic writings were usually concerned with the idea of economic growth and its causes, perhaps another example of an intellectual focus that he bequeathed to Smith. Hume was sometimes inconsistent in his economic theorizing. In one place he might praise the growth of the money supply, while in another he would correctly show that larger supplies of money lead to rising prices. Smith might also have taken from Hume the deeply flawed labor theory of value, as Hume routinely argued that only labor conveyed value. On balance, Hume favored "hard money"—that is, money made of precious metals that had "intrinsic value." He also seemed to support ultrasound banking, as when he praised the Bank of Amsterdam for its policy of 100 percent specie-backed deposit reserves (Rothbard 1995, 428).

While arguing that an increase in the money supply is neutral regarding the rate of interest, he also concluded that, in the long run, such a continuing increase might actually *lower* the interest rate. Although Hume had insights into many important economic issues, his analysis was primarily one of comparative statics, or examinations of equilibrium positions. He seldom discussed in detail the microeconomic adjustment processes that occur between these equilibria, with the exception of his essay *Of Money*.

Smith's analysis of economic growth and society owes a great deal to his having read Hume's massive *The History of England*. Hume wrote the four-volume work between 1754 and 1762 while librarian at the Advocates' Library in Edinburgh after failing for the second time to secure a university appointment at Glasgow. Hume contended that commercial society's birth and growth generated more ben-

Public Debt: Does Anything Ever Really Change?

But though the injury that arises to commerce and industry from our public funds will appear, upon balancing the whole, not inconsiderable, it is trivial in comparison of the prejudice that results to a state considered as a body politic, which must support itself in the society of nations, and have various transactions with other states in wars and negotiations. The ill there is pure and unmixed, without any favorable circumstance to atone for it; and it is an ill too of a nature the highest and most important.

We have indeed been told, that the public is no weaker on account of its debts, since they are mostly due among ourselves, and bring as much property to one as they take from another. It is like transferring money from the right hand to the left, which leaves the person neither richer nor poorer than before. Such loose reasoning and specious comparisons will always pass where we judge not upon principles. I ask, Is it possible, in the nature of things, to overburden a nation with taxes, even where the sovereign resides among them? The very doubt seems extravagant, since it is requisite, in every community, that there be a certain proportion observed between the laborious and the idle part of it. But if all our present taxes be mortgaged, must we not invent new ones? And may not this matter be carried to a length that is ruinous and destructive?

In every nation there are always some methods of levying money more easy than others, agreeably to the way of living of the people, and the commodities they make use of.... Duties upon consumptions are more equal and easy than duties upon possessions. What a loss to the public that the former are all exhausted, and that we must have recourse to the more grievous method of levying taxes!...

It will scarcely be asserted, that no bounds ought ever to be set to national debts, and that the public would be no weaker were twelve or fifteen shillings in the pound, land-tax, mortgaged, with all the present customs and excises. There is something, therefore, in the case, beside the mere transferring of property from the one hand to another. In five hundred years, the posterity of those now in the coaches, and of those upon the boxes, will probably have changed places, without affecting the public by these revolutions....The funds, created and mortgaged, will by that time bring in a large yearly revenue, sufficient for the defense and security of the nation: money is perhaps lying in the exchequer, ready for the discharge of the quarterly interest: necessity calls, fear urges, reason exhorts, compassion alone exclaims: the money will immediately be seized for the current service, under the most solemn protestations, perhaps of being immediately replaced. But no more is requisite. The whole fabric, already tottering, falls to the ground, and buries thousands in its ruins. And this, I think, may be called the *natural death* of public credit; for to this period it tends as naturally as an animal body to its dissolution and destruction. ■

—"Of Public Credit," *Economic Essays*, 207–14

Paper Money and Sound Banking

This [the dearness of things due to excessive quantities of money] has made me entertain a doubt concerning the benefit of *banks* and *paper-credit*, which are so generally esteemed advantageous to every nation. That provisions and labor should become dear by the increase of trade and money is, in many respects, an inconvenience; but an inconvenience that is unavoidable, and the effect of that public wealth and prosperity which are the end of all our wishes. It is compensated by the advantages, which we reap from the possession of these precious metals, and the weight, which they give the nation in all foreign wars and negotiations. But there appears no reason for increasing that inconvenience by a counterfeit money, which foreigners will not accept of in any payment, and which any great disorder in the state will reduce to nothing. There are, it is true, many people in every rich state, who having large sums of money, would prefer paper with good security; as being of more easy transport and more safe custody. If the public provide not a bank, private bankers will take advantage of this circumstance; as the goldsmiths formerly did in London, or as the bankers do at present in Dublin. And therefore it is better, it may be thought, that a public company should enjoy the benefit of that paper-credit, which always will have place in every opulent kingdom. But to endeavor artificially to increase such a credit, can never be the interest of any trading nation; but must lay them under disadvantages, by increasing money beyond its natural proportion to labor and commodities, and thereby heightening their price to the merchant and manufacturer. And in this view, it must be allowed, that no bank could be more advantageous, than such a one as locked up all the money it received, and never augmented the circulating coin, as is usual, by returning part of its treasure into commerce. A public bank, by this expedient, might cut off much of the dealings of private bankers and money-jobbers; and though the state bore the charge of salaries to the directors and tellers of this bank (for, according to the preceding supposition, it would have no profit from its dealings), the national advantage, resulting from the low price of labor and the destruction of paper-credit, would be a sufficient compensation. Not to mention, that so large a sum, lying ready at command, would be a convenience in times of great public danger and distress; and what part of it was used might be replaced at leisure, when peace and tranquillity was restored to the nation. ■

—"Of Money," *Essays, Moral, Political, and Literary*

efits than costs, a stance he developed while writing his history of Britain. He was not a typical advocate of laissez-faire capitalism, though, even supporting some mild protectionist policies, as did Smith in his *Wealth of Nations*.

For Hume, and then Smith, commercial society was a form of social contract, a method of controlling human passions in a way that increased output that all might share, regardless of the effect on individuals. Smith based his own "system of natural liberty" on this idea, which Hume so skillfully demonstrated in his writings. Unsurprisingly, both men were opposed to gross restrictions on international trade, and Hume in particular worked out his specie-flow mechanism in part to discredit protectionist, mercantile doctrine. After he and Smith had finished with it, mercantile theory was intellectually dead, although its protectionist tendencies have always been a part of international trade policy and remain so for many nations even today.

It is perhaps fitting that Hume died in 1776, the year Smith published his famous work of political economy, *Wealth of Nations*, most of which Hume told Smith he agreed with. Coming at the beginning of the classical period, Hume's own economic writings—as well as his impact on Smith—make him still worthy of careful study by anyone interested in the history of ideas generally and in the evolution of economic theory specifically. ■

— **Robert L. Formaini**
Senior Economist

The Virtue of Foreign Trade

If we consult history, we shall find, that in most nations foreign trade has preceded any refinement in home manufactures, and given birth to domestic luxury. The temptation is stronger to make use of foreign commodities which are ready for use, and which are entirely new to us, than to make improvements of any domestic commodity, which always advance by slow degrees, and never affect us by their novelty. The profit is also very great in exporting what is superfluous at home, and what bears no price, to foreign nations whose soil or climate is not favorable to that commodity. Thus men become acquainted with the *pleasures* of luxury, and the *profits* of commerce; and their *delicacy* and *industry* being once awakened, carry them on to further improvements in every branch of domestic as well as foreign trade; and this perhaps is the chief advantage which arises from a commerce with strangers. It rouses men from their indolence; and, presenting the gayer and more opulent part of the nation with objects of luxury which they never before dreamed of, raises in them a desire of a more splendid way of life than what their ancestors enjoyed. And at the same time, the few merchants who possessed the secret of this importation and exportation, make great profits and, becoming rivals in wealth to the ancient nobility, tempt other adventurers to become their rivals in commerce. Imitation soon diffuses all those arts, while domestic manufacturers emulate the foreign in their improvements, and work up every home commodity to the utmost perfection of which it is susceptible. Their own steel and iron, in such laborious hands, become equal to the gold and rubies of the Indies.

When the affairs of society are once brought to this situation, a nation may lose most of its foreign trade, and yet continue a great and powerful people. If strangers will not take any particular commodity of ours, we must cease to labor in it. The same hands will turn themselves towards some refinement in other commodities which may be wanted at home; and there must always be materials for them to work upon, till every person in the state who possesses riches, enjoys as great plenty of home commodities, and those in as greater perfection, as he desires; which can never probably happen. ■

—"Of Commerce," *Selected Essays,* 163–64

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Do Low Interest Rates Stimulate Economic Activity?

Nothing is esteemed a more certain sign of the flourishing condition of any nation than the lowness of interest: and with reason, though I believe the cause is somewhat different from what is commonly apprehended. Lowness of interest is generally ascribed to plenty of money. But money, however plentiful, has no other effect, *if fixed*, than to raise the price of labor. Silver is more common than gold, and therefore you receive a greater quantity of it for the same commodities. But do you pay less interest for it? Interest in Batavia and Jamaica is at 10 *percent*, in Portugal at 6, though these places, as we may learn from the prices of every thing, abound more in gold and silver than either London or Amsterdam.

Were all the gold in England annihilated at once, and one and twenty shillings substituted in the place of every guinea, would money be more plentiful, or interest lower? No, surely: we should only use silver, instead of gold. Were gold rendered as common as silver, and silver as common as copper, would money be more plentiful, or interest lower? We may assuredly give the same answer. Our shillings would then be yellow, and our halfpence white; and we should have no guineas. No other difference would ever be observed; no alteration on commerce, manufactures, navigation, or interest; unless we imagine that the color of the metal is of any consequence…. If the multiplying of gold and silver fifteen times makes no difference, much less can the doubling or tripling of them. All augmentation has no other effect than to heighten the price of labor and commodities; and even this variation is little more than that of a name. In the progress towards these changes, the augmentation may have some influence, by exciting industry; but after the prices are settled, suitably to a new abundance of gold and silver, it has no manner of influence.

An effect always holds proportion with its cause. Prices have risen near four times since the discovery of the Indies; and it is probable gold and silver have multiplied much more: but interest has not fallen much above half. The rate of interest, therefore, is not derived from the quantity of the precious metals. Money having chiefly a fictitious value, the greater or less plenty of it is of no consequence, if we consider a nation within itself; and the quantity of specie, when once fixed, though ever so large, has no other effect than to oblige every one to tell out a greater number of those shining bits of metal for clothes, furniture, or equipage, without increasing any one convenience of life. ■

—"Of Interest," *Selected Essays,* 177–79

Why Commerce Encourages Both Low Profits and Low Interest Rates

Low interest and low profits of merchandise are two events, that mutually forward each other, and are both originally derived from that extensive commerce, which produces opulent merchants, and renders the monied interest considerable. Where merchants possess great stocks…it must frequently happen, that, when they either become tired of business, or leave heirs unwilling or unfit to engage in commerce, a great proportion of these riches naturally seeks an annual and secure revenue. The plenty diminishes the price, and makes the lenders accept of a low interest. This consideration obliges many to keep their stock employed in trade, and rather be content with low profits than dispose of their money at an under-value. On the other hand, when commerce has become extensive, and employs large stocks, there must arise rivalships among the merchants, which diminish the profits of trade, at the same time that they increase the trade itself. The low profits of merchandise induce the merchants to accept more willingly of a low interest, when they leave off business, and begin to indulge themselves in ease and indolence. It is needless, therefore, to inquire which of these circumstances, to wit, *low interest or low profits*, is the cause, and which the effect? They both arise from an extensive commerce, and mutually forward each other. ■

—"Of Interest," *Selected Essays,* 184–85

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